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November 10, 1993

William H. Johnson
Deputy Chief
Mass Media Bureau
Federal Communications Commission
1919 M Street N.W. - Room 314
Washington, D. C. 20554

Larry Miller
Assistant Chief
Video Services Division
Mass Media Bureau
Federal Communications Commission
1919 M Street N.W. - Room 702
Washington, D. C. 20554

Hugh Boyle
Cable Services Division
Federal Communications Commission
2033 M Street N.W. - Room 802
Washington, D. C. 20554

Re: **MM Docket 92-266**

Dear Messrs. Johnson, Miller, and Boyle:

On behalf of the Coalition of Small System Operators, I want to thank you for the time you took to meet with us on Monday. The meeting helped us better understand your concerns, and we would like to further address them here.

The Coalition consists of about 25 operators of small cable systems serving 1.2 million customers. The vast majority of these subscribers are served

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by systems of less than 1,000 subscribers. In all, the Coalition members operate about one-quarter of all of the cable headends in the country.

As you are aware, we have proposed two primary alternatives for small system relief. These are the Net Income Analysis and the Density Factor add-on to the benchmark. These approaches are not mutually exclusive. At this point we can all agree that there is no perfect answer to administrative relief for small systems. Any approach can be argued either to be too simplistic or too burdensome, if not both. By addressing your major issues on the Net Income Analysis, we believe we can make it acceptable for very small systems (less than 1,000) which represent only 3.6 percent of cable subscribers nationally. 1/ Yet these systems also represent over 50 percent of all cable head-ends. 2/ Simplifying rate regulation for small systems can have an enormous impact on the total administrative costs for cable operators, franchising authorities, and the FCC. Yet relatively few subscribers will be impacted. We believe the overall cost-benefit analysis of small system relief is unquestionably positive. The Density Factor could be applied where the Net Income Approach fails or for small head-ends with over 1,000 customers.

Net Income Analysis

- What is the theory behind the net income approach?

The net income approach is designed to free from further rate regulation any small systems which can simply demonstrate that their overall revenues do not exceed their overall expenses by an excessive amount. The approach compares the system's total revenues (including unregulated revenues) to the system's total expenses: operating expenses, interest, and depreciation (excluding amortization). If the comparison shows that revenues do not exceed these expenses by an amount that is unquestionably reasonable, the operator's rates themselves are determined to be reasonable. Although there are certainly refinements that could be made to the analysis, we emphasize that the object is to create a simple analysis. And we note that all revenues are included, including revenues that would be unregulated under the 1992 Cable Act.

1/ Implementation of Sections of the Consumer Protection and Competition Act of 1992, Rate Regulation, Memorandum Opinion and Order and Further Notice of Proposed Rulemaking, FCC 93-389 (rel. Aug. 10, 1993), Separate Statement of Commissioner Ervin S. Duggan at 1.

2/ Id. at Concurring Statement of Commissioner Andrew C. Barrett at 6.

As in any simplified approach, there may be corrections that could be made on either side. In this regard, our proposal is not wholly dissimilar from the simplified analysis used by the Commission in analyzing pole attachment rates. The net income approach is even simpler in view of the fact that (1) there are many more small cable systems in the country than the investor-owned utilities that are subject to the Pole attachment Act; 3/ (2) the cable systems at issue (those with less than 1,000 customers) are smaller by many orders of magnitude than the utilities subject to the Pole Attachment Act; and (3) cable systems do not maintain any Uniform System of Accounts.

- What is the relationship between net income and reasonable rates?

A traditional cost of service analysis takes into consideration operating expenses, depreciation, taxes, and a return on net assets which factors in the cost of the capital structure -- interest and equity return. Up to the point of break-even, the Net Income Analysis is essentially a primitive cost-of-service approach. All that is considered in the Net Income Analysis is operating expenses, depreciation, and interest. If the system's regulated and unregulated revenue does not exceed by some unquestionably reasonable percentage its overall expenses, the Net Income Approach presumes that the rates for regulated services must be themselves reasonable. To the extent that rates are considered reasonable when they are related directly to expenses, the Net Income Approach simply compares the two. Each of the expenses considered is a real cost of doing business.

The primary difference between the Net Income Analysis and the traditional Cost-of-Service Analysis is that the former attempts to measure a conservatively reasonable return solely by looking to pre-tax income as related to expenses and the latter looks to after-tax income as a percentage of the "rate base." There is no requirement that the FCC make all decisions as to rate reasonableness based on traditional cost-of-service principles. And, indeed, the Commission has based its primary rate regulation on a wholly different concept -- rate benchmarks. Because determining a rate base can be complicated and is extremely contentious, we have proposed the Net Income Approach as a more simple and less contentious alternative.

3/ Cooperatives and municipally-owned utilities are exempted from the Pole Attachment Act.

- How do we reconcile differing depreciation schedules that may be used by small system operators?

We believe that so long as the depreciation methods meet the requirements of GAAP, they should be acceptable.

- At what level of consolidation should the Net Income Analysis be applied?

We believe it must be applied at the level where books were kept on April 1, 1993. The next question is, obviously, how does this relate to the circumstances in a particular franchise within this entity? The answer is that it won't exactly reflect those circumstances; however, no amount of allocation of expenses to the franchise level will correct this situation. Allocations are inherently arbitrary and cannot possibly reflect the true operating environment of a particular franchise. It should also be noted that any cost-of-service showing will have these same limitations.

- What is the basis of the 15.5 percent of revenue figure proposed with the Net Income Analysis?

We believe it is beyond serious dispute that a small system's rates are reasonable if they do not cover the system's operating expenses, depreciation, and interest expense. But we also believe that all reasonable people must agree that the rates are reasonable if they earn only some minimal income above these expenses. The figure proposed by the Coalition of 15.5 percent of revenue is intended to be a non-controversial figure. If the Commission has some basis for selecting some other number as more satisfactory, it may do so.

Arthur Andersen's Anthony Kern has analyzed a total of 562 profitable companies across a range of industrial classifications. After review of these companies and eliminating companies with extraordinarily high income, he determined that the weighted average net income margin (revenues, less interest, depreciation, amortization, taxes, and operating expenses) for these companies was 15.5 percent. In reaching this determination for these companies, he subtracted amortization and taxes from revenues. The Net Income Analysis for small cable systems, on the other hand, does <u>not</u> treat taxes <u>or</u> amortization as expenses. The result is that a small cable system under our Net Income Analysis that shows a 15.5 percent net income as a percentage of total revenues will have considerably less revenue than a similarly situated industrial company in Mr.

Kern's study. We believe the 15.5 percent number is thus extremely conservative and may be relied upon by the Commission.

- How should we handle "excess" acquisition costs and the related interest?

It should first be noted that this is not a large problem in small systems with less than 1,000 subscribers. High acquisition prices in the cable industry have typically been driven by customer growth potential and the opportunity to enhance revenues through advanced services like pay-per-view, advertising, etc. These opportunities don't exist to a significant degree for small systems.

Even given these factors, we have excluded amortization of intangibles from the analysis. There is ample support in traditional cost-of-service showings for allowing the interest component for disallowed capital expenditures. However, in this case, the most important point is that these costs would not be material. We are not aware of any allegations -- either in Congress or before the FCC -- that small cable systems have been traded at unreasonable values or that subscribers have been abused by "trafficking" in these systems.

A related issue is the level of interest expense as driven by the debt-to-equity ratio. First of all, the small systems' capital structures were established pre-regulation. They have not been juggled or "gamed" to manipulate the regulatory system. Second, the banking industry has tightened its lending limits to such an extent that extremely high debt-to-equity ratios are almost impossible today. A third consideration is that while the Net Income Analysis only factors in interest expense, in reality equity is the more expensive component of a capital structure. The Net Income Analysis is conservative in that it only recognizes the interest component, and this only to the extent actually incurred. A true cost-of-service showing would allow a return on the equity component also. We believe that by including only the expenses that it does, the Net Income Approach is extremely conservative.

- How should subsequent channel additions be handled?

We note that the Net Income Approach would only be used to justify a small system's rates as of April 5, 1993, the date of the Commission's first rate freeze. Rates justified in this manner would be subject generally to the Commission's price cap standards, including rules on passing through external costs.

When a small system then adds to the number of channels offered, we suggest an approach similar to the approach proposed by the Commission for larger systems that add channels. We propose that the system be permitted to pass through the actual increase in programming costs the operator incurs. Instead of also raising its permitted rates based solely on the number of new channels, 4/ we suggest that the small operators be allowed to pass through the actual cost (amortized according to GAAP) of any associated required headend investment. These costs are significant on a per-subscriber basis for small operators. 5/ And by passing through the actual related costs directly, the small operators would continue to be relieved of the administrative burden of making benchmark calculations for their systems.

We note that the FCC is also considering whether to allow other upgrading costs to be passed through as an "external cost," and whether to permit a return of programming expenses. We believe the small systems should be permitted to follow the general decisions reached by the Commission.

- How do we get comfortable with the expenses in the analysis?

We believe that in addressing the questions raised by the Staff, we have addressed all areas for material manipulation of the results. This is where the trade-offs begin. To get into more detail would negate the stated objective of reducing the administrative burden on small systems. Sworn affidavits from officers and, perhaps, some random audits could give further comfort in these areas.

4/ The FCC has proposed to allow systems to use new benchmarks for the increased number of channels. Although the per-channel amount decreases as the number of channels increases under the benchmarks, the overall permitted revenue from regulated services increases on the order of 10-15 cents a channel. For example, under the benchmarks, if a cable system with 10,000 or more subscribers increases the number of regulated channels from 30 to 40 (assume the number of satellite channels increases from 20 to 30), the rate per channel decreases from \$0.693 to \$0.559, while the overall permitted revenue increases from \$20.79 to \$22.36 -- an increase of 15.7 cents per channel.

5/ For example, one small system spent \$76,800 to add 64 new must carry channels, or \$1200 per channel. For a system of 1,000 subscribers, this cost would be \$12 per subscriber. See Comments of Coalition of Small System Operators in MM Docket No. 92-266, August 31, 1993.

Density Factor

While this didn't receive much attention in our discussions, we want to restate the importance to us of this approach. Density is the most critical economic factor in rural systems. The Coalition members have brought cable service to some extremely low-density areas. We are only asking that rural systems be allowed to recover their relatively high capital investment. As detailed in the Coalition's Petition for Reconsideration in MM Docket 92-266 (filed June 21, 1993), density has a dramatic impact on system profitability. We are asking that a portion of this impact be allowed to be reflected in the benchmark approach to avoid lengthy cost-of-service showings.

We believe that the cost estimates submitted by Arthur Andersen's Anthony Kern provide a solid basis for calculating a density factor. 6/ You may note from his Declaration that his estimates are based on his work with nearly 6,000 cable systems.

Please don't hesitate to contact me if I can be of further assistance.

Sincerely,

Gardner F. Gillespie

cc: Maureen O'Connell
Lisa Smith
John C. Hollar
Docket MM 92-266

6/ See the Coalition's Supplement to Petition for Reconsideration, MM Docket No. 92-266, filed on July 20, 1993.